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**Facts:**

Company is a “to be formed” State corporation that will elect to be taxed as a real estate investment trust (“REIT”) for federal income tax purposes. The Taxpayer expects the Company to finance Structural Improvements secured by the Structural Improvements and the underlying building or facility. The Structural Improvements are long lived permanent improvements to buildings or facilities that are designed to improve the the building or facility. Some larger Structural Improvements may be constructed as a separate structure adjacent to a building or facility and connected, with . The Structural Improvements are intended solely for the use of the building or facility and it is not the purpose of the Structural Improvements to operate a business or or other products to a third party. The Structural Improvements are located on the building or facility owner’s real property, are necessary for the building or facility to function and would be included in the mortgage and/or sale if the real property was financed or sold.

In a typical financing, the owner of a building or facility (the “Owner”) enters into a contract (“Contract”) with a contractor (the “Contractor”) for the installation of the Structural Improvements. The Contractor is also responsible for soliciting financing bids. The Contract establishes a payment schedule from the Owner and a security interest in the installed Structural Improvements for the third party financier. Upon completion of the construction, the Owner accepts the project and takes legal title to the Structural Improvements, subject to the security interest granted to the third party financier.<sup>1</sup>

Currently, Taxpayer bids to provide the financing for these Contracts and, if successful, finalizes various financing terms including interest rate, amortization schedule, security interest and term of the financing (averaging over X years, but as long as Y years). Taxpayer is assigned the payment stream due under the Contract. Under the terms of the financing, the Contractor is prohibited from modifying the underlying Contract in a way that would impact the payment stream assigned to the Taxpayer and the Contractor is required to file any claims or appeals on behalf of the Taxpayer. The Contract may provide a warranty on the Structural Improvements or, in some cases, a guarantee . The Contractor holds Taxpayer harmless for any warranty or guarantee claims. To date the Taxpayer’s collections on these warranty or guarantee claims have been less than A% of total financings. In the absence of default by the Owner under the Contract, Taxpayer’s return on any particular Contract is fixed and determinable.

Some contracts include an ongoing obligation to operate and maintain the in good working order for a defined period of time in exchange for a separate payment stream. The Taxpayer does not provide any services, retain any rights to the separate payment, or share in any of the Contractor’s profit or losses from the Contracts.

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<sup>1</sup>In some cases, the Contractor retains nominal title until the Contract payments are made.

Moreover, the Taxpayer does not have any joint venture or partnership relationship with the Contractors and all financings are conducted on an arm's-length basis.

Taxpayer is the beneficial owner of a trust ("Trust"), which is treated as a disregarded entity, through which most of the Taxpayer's Contract financing activities are undertaken. Taxpayer typically assigns all of its rights under a Contract to the Trust. The Trust issues notes to third party investors ("Investor Notes"). There is typically a difference on the interest rates on the financing under the Contract and the Investor Notes, this difference is retained by the Taxpayer as owner of the Trust.

Taxpayer intends to form the Company, which will elect to be taxed as a REIT, to which it will contribute its beneficial interest in the Trust, together with other assets. The Taxpayer expects the Company to raise equity in the capital markets, and use the funds raised to purchase some of the then outstanding Investor Notes and purchase other assets. Going forward, the Company (directly or through one or more trusts or subsidiaries) will continue the activity of providing Contract financing to the Contractors.

The Taxpayer represents that the Company (directly or through one or more trusts or subsidiaries) will in each case have a valid security interest that, in the case of default by the owner, provides the holder with the rights of a secured party, including the right to bring a foreclosure action with respect to the Structural Improvements and the real property into which the Structural Improvements have been installed.

## **Law and Analysis:**

### **Issue 1 - Real Estate Assets**

Section 856(c)(5)(B) of the Code defines the term "real estate assets", in part, to mean real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs. Section 856(c)(5)(C) of the Code provides that the term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil, or gas royalty interests.

Section 1.856-3(b)(1) of the Income Tax Regulations provides that the term "real estate assets" means real property, interests in mortgages on real property (including interests in mortgages on leaseholds of land or other improvements thereon), and shares in other qualified REITs. The term "mortgages on real property" includes deeds of trust on real property.

Section 1.856-3(c) provides that the term “interests in real property” includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

Section 1.856-3(d) provides that the term “real property” means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items that are structural components of those buildings or structures). In addition, real property includes interests in real property. Local law definitions do not control for purposes of determining the meaning of the term real property as used in section 856 of the Code and the regulations thereunder. The term includes, for example, the wiring of a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items that are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment that is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though those items may be termed fixtures under local law.

Rev. Rul. 75-424, 1975-2 C.B. 270, concerns whether various components of a microwave transmission system are real estate assets for purposes of section 856 of the Code. The system consists of transmitting and receiving towers built upon pilings or foundations, transmitting and receiving antennae affixed to the towers, a building, equipment within the building, and waveguides. The waveguides are transmission lines from the receivers or transmitters to the antennae, and are metal pipes permanently bolted or welded to the tower and never removed or replaced unless blown off by weather. The transmitting, multiplex, and receiving equipment is housed in the building. Prewired modular racks are installed in the building to support the equipment that is installed upon them. The racks are completely wired in the factory and then bolted to the floor and ceiling. They are self-supporting and do not depend upon the exterior walls for support. The equipment provides for transmission of audio or video signals through the waveguides to the antennae. Also installed in the building is a permanent heating and air conditioning system. The transmission site is surrounded by chain link fencing. The revenue ruling holds that the building, the heating and air conditioning system, the transmitting and receiving towers, and the fence are real estate assets. The ruling holds further that the antennae, waveguides, transmitting, receiving, and multiplex equipment, and the prewired modular racks are assets accessory to the operation of a business and therefore not real estate assets.

Rev. Rul. 73-425, 1973-2 C.B. 222, considers four situations where a trust owns a mortgage interest in a total energy system. A total energy system is a self-contained facility for the production of all the electricity, steam or hot water, and refrigeration needs of associated commercial or industrial buildings, building complexes, shopping

centers, apartment complexes, and community developments. The system may be permanently installed in the building, attached to the building, or it may be a separate structure nearby. The principal components consist of electric generators powered by turbines or reciprocating engines, waste heat boilers, heat exchangers, gas-fired boilers, and cooling units. In addition, each facility includes fuel storage tanks, control and sensor equipment, electrical substations, and air handling equipment for heat, hot water, and ventilation. It also includes ducts, pipes, conduits, wiring, and other associated parts, machinery and equipment.

In situation 1, the trust made a loan for the purpose of constructing a total energy system which is permanently installed in the building which it serves. In return, the trust received an obligation secured by a mortgage covering the total energy system.

In situation 2, the facts are the same as in situation 1 except that the obligation received by the trust is secured by a mortgage covering not only the total energy system, but also the building served by the system. The terms of the mortgage interest in the facilities are the same as the terms of the mortgage interest in the building served by the total energy system.

In situation 3, the facts are the same as in situation 2 except that the total energy system is housed in a separate structure apart from the building which it serves.

In situation 4, a bank advanced permanent mortgage financing covering 80 percent of the cost of construction of a shopping center complex, including the total energy system. The bank received a mortgage covering the entire shopping center project, including the total energy system. The trust purchased an undivided 50 percent interest in the mortgage note held by the bank. The terms of the mortgage interest in the total energy system are the same in every respect as the terms of the mortgage interest in the buildings served by the total energy system.

Rev. Rul. 73-425 held that: (1) the mortgage in situation 1 does not qualify as a real estate asset within the meaning of section 856(c)(6)(B) of the Code since the mortgage is secured only by the total energy system; (2) the mortgage in situations 2 and 3 qualify as real estate assets within the meaning of section 856(c)(6)(B) of the Code; and (3) as to the trust, the undivided 50 percent interest in the mortgage in situation 4 qualifies as a real estate asset within the meaning of section 856(c)(6)(B) of the Code.

Similar to the properties or structural components described in Rev. Rul. 75-424 and Rev. Rul. 73-425 that qualify as real property for purposes of section 856 of the Code, the Structural Improvements described above are inherently permanent structures and not assets accessory to the operation of a business like the examples set forth in section 1.856-3(d). Therefore, the Structural Improvements that are structural components of real property are also real property.

Rev. Rul. 73-425 holds, in part, that a mortgage secured by the building and the total energy system is a real estate asset regardless of whether the system is housed in the building it serves or is housed in a separate structure apart from the building it serves. This is because the interest in a structural component is included with an interest held in a building or inherently permanent structure to which the structural component is functionally related. In this case, the Company's interest will be secured by the Structural Improvements and the real property into which the Structural Improvements have been installed.

The Taxpayer has represented that the Company will in each case have a valid security interest that, in the case of default, provides the holder with the rights of a secured party, including the right to bring a foreclosure action with respect to the Structural Improvements and the real property into which the Structural Improvements have been installed. The security interest in the Structural Improvements (and the building or facility in which they are installed as structural components) are conveyed at the time of financing to secure payments under the financing. Therefore, the Company's interests in the Structural Improvements constitute interests in mortgages on the Structural Improvements and the real property into which the Structural Improvements have been installed.

Accordingly, based on the information submitted and representations made, we conclude that the Company's interests in the Structural Improvements constitute "real estate assets" for purposes of section 856(c)(5)(B) of the Code.

## **Issue 2 - Interest on Obligations Secured by Mortgages on Real Property**

Section 856(c)(2) of the Code provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, "interest."

Section 856(c)(3) of the Code provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, "interest on obligations secured by mortgages on real property or on interests in real property."

Section 856(f) of the Code provides, in part, that the term "interest" excludes any amount received or accrued, directly or indirectly, if the determination of such amount depends in whole or in part, on the income or profits of any person except that any amount so received or accrued will not be excluded from the term "interest" solely by reason of being based on a fixed percentage or percentage of receipts or sales.

Section 1.856-5(c)(1) provides that where a mortgage covers both real and other property an apportionment of the interest income must be made for purposes of the 75-percent requirement.

Section 1.856-5(c)(2) provides, in part, that the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to make the loan becomes binding on the trust. However, in the case of a construction loan or other loan made for purposes of improving or developing real property, the loan value of the real property is the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) which will secure the loan and which are to be constructed from the loan proceeds of the loan. The fair market value of the land and the reasonably estimated cost of improvements or developments shall be determined as of the date on which a commitment to make the loan becomes binding on the trust.

Here, the Company will have a loan secured by the Structural Improvements and the real property in which it is installed. The payments under the financing are not contingent on any further action by the Company and are not determined by the income or profits of any other person but rather as compensation for the use or forbearance of money. Therefore, interest income from the financing of Structural Improvements qualifies as interest on obligations secured by mortgages on real property or interests in real property within the meaning of section 856(c)(3)(B) of the Code.

### **CONCLUSION**

Based on the facts as represented, we rule that:

- (i) the Company's interests in the Structural Improvements constitute "real estate assets" for purposes of Section 856(c)(5)(B) of the Code; and
- (ii) the Company's interest income from the financing of Structural Improvements qualifies as interest on obligations secured by mortgages on real property or interests in real property for purposes of section 856(c)(3) of the Code.

No opinion is expressed or implied as to the federal income tax consequences of this transaction under any provision not specifically addressed herein. Specifically, no opinion is expressed or implied whether the Structural Improvements constitute real property under any section of the Code other than section 856. Furthermore, no opinion is expressed concerning whether Company otherwise qualifies as a REIT under subchapter M, part II of Chapter 1 of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Diana Imholtz

Diana Imholtz

Branch Chief, Branch 1

Office of Associate Chief Counsel

(Financial Institutions & Products)